No. 03-171

Supreme Court, U.S.
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In The Supreme Court of the United States

STERLING HOLDING COMPANY, LLC, and
NATIONAL SEMICONDUCTOR CORPORATION,

Petitioners,

v.

MARK LEVY,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

REPLY TO BRIEF IN OPPOSITION

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REPLY BRIEF FOR PETITIONERS

Respondent does not dispute that the decision below makes it difficult, if not impossible, for corporate insiders to predict whether particular transactions will expose them to liability under section 16(b) of the Securities Exchange Act of 1934. The court of appeals held that two exemptive rules promulgated by the Securities and Exchange Commission (the "Commission") – the agency Congress expressly charged with exempting transactions "not comprehended within the purpose" of the statute – do not mean what they say, and what the Commission says they mean. In doing so, the court of appeals violated clear precedents laid down by this Court, opened up a split in the circuits, and cast a pall of uncertainty over this entire area of the law.

In an apparent effort to deflect attention from these issues, respondent ranges far afield from the actual legal question presented by this petition – whether the court of appeals erred when it failed to give deference to the Commission and its exemptive rules. As a consequence, respondent's brief surveys such topics as "hot" initial public offerings ("IPOs"), the Commission's lack of "enforcement" authority with respect to section 16(b), and an alleged absence of "evidence" that the court of appeals' decision caused actual market disruption. Each of these subjects is, of course, completely and utterly irrelevant to the issue before the Court. It is the failure of the court of appeals to give weight to the Commission's exemptive rules and its interpretation of those rules which necessitates review in this Court.[1]

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[1] The Commission's view in this case is quite clear in the record. (*See* App. at 64a-81a.) However, if this Court has any doubt about the level of concern with which the Commission views the decision below, petitioners respectfully suggest that the Court now solicit the input of the Commission.

1. Respondent's Assertions Regarding "the Hot IPO Market of 1998-2000" Have Nothing to Do With This Case.

Respondent argues that IPOs are "subject to speculative abuse" because "[i]nsiders [can buy] at the severely discounted price necessary to make an offering 'hot' with the goal of turning a quick profit by selling in the aftermarket." (Br. in Opp. at 3.) According to respondent, that is exactly "what petitioners did here." (*Id.*)

Whether IPOs are "subject to speculative abuse," however, was not the issue before the court of appeals. The issue was whether the Commission, acting pursuant to its congressionally-delegated authority to promulgate exemptions to section 16(b), and with the benefit of its expertise in securities law issues, exempted the type of transaction here that respondent characterizes as a "purchase."

Significantly, this case is about a reclassification, not an IPO. Respondent's complaint did not allege that petitioners purchased shares in the IPO of Fairchild Semiconductor Corporation, Inc. ("Fairchild"). On the contrary, the complaint alleged that, prior to Fairchild's IPO, all outstanding shares of the company's preferred stock, including those shares held by petitioners, were reclassified and converted into shares of the company's class A common stock. (*See* A25.) Respondent's section 16(b) claim was premised solely on the theory that this reclassification was a "purchase," (*see* A26), and the subsequent mechanical application of section 16(b). There was no assertion of, and the theory of respondent's case was not premised on, wrongdoing with respect to the IPO.

Moreover, although the reclassification was undertaken to *facilitate* Fairchild's IPO, it involved no new investment in the company by petitioners. Thus, there was no opportunity for the kind of speculative abuse that section 16(b) was designed to prevent. Significantly, respondent never even attempts to explain how a reclassification of preferred stock into common in the

circumstances of this case could raise the specter of a speculative profit earned through a quick in-and-out, short-swing trade. Indeed, petitioners' only "in" occurred in 1997, when they acquired the preferred stock. The reclassification simply changed the form, but not the substance, of petitioners' pre-existing investment in Fairchild.

Respondent tries to suggest that the preferred stock was reclassified into common at a "severely discounted price." (Br. in Opp. at 3; *see also id.* at 21.) As respondent acknowledges, however, the conversion ratio was based on the undisputed pre-set value of the preferred and the price Fairchild received for shares of class A common stock sold in the IPO.[3] (*See id.* at 4.) The Commission has found a similar reclassification, involving a virtually identical conversion formula, exempt under Rule 16b-7. *See Monk-Austin, Inc.*, SEC No-Action Letter, 1992 Fed. Sec. L. Rep. (CCH) ¶ 76,296, 1992 WL 337451 (Nov. 19, 1992). In reaching that decision, the Commission correctly noted that the transaction simply was not "subject to insider abuse." *Id.* at *4. Respondent offers no basis for an alternative conclusion here.

Respondent also contends that Fairchild's class A common stock "skyrocketed in price" after the IPO, as if a post-IPO price increase is proof of "speculative abuse." (Br.

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[3] It is common for there to be a disparity between the initial offering price and the market price that prevails following the IPO. As a case cited by respondent explains:

> When a company goes public, the initial offering price (the price paid by the first customer) is established by the company and underwriters. Once issued, the stock price is determined by the market. For at least five decades, studies have shown that IPOs generally trade on the open market at a price significantly higher than the offering price . . . .

In re Initial Public Offering Sec. Litig., 241 F. Supp. 2d 281, 299 (S.D.N.Y. 2003).

in Opp. at 21; *see also id.* at 3.) However, an increase in price following an IPO shows only that the market values a stock more highly than the initial offering price; it does not necessarily indicate any wrongdoing.[3] Respondent's assertions that Fairchild's IPO took place in a "hot issues market," or was itself a "hot" issue,[4] are beside the point.

Finally, in a desperate attempt to create the impression that the reclassification altered more than the form of petitioners' investments in Fairchild, respondent claims that "[t]he economic change was so great that defendant National Semiconductor recorded a $48.4 million gain upon completion of Fairchild's IPO before it ever sold a single share of stock." (Br. in Opp. at 21.) But this gain resulted from National's initial 1997 investment and the sale of class A common stock in the IPO – not from the reclassification, as respondent misleadingly suggests.

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[3] *Initial Public Offering Securities Litigation* is not to the contrary. In that case, the plaintiffs alleged that various underwriters engaged in fraudulent schemes designed to *artificially* drive up market prices following particular IPOs. *See* 241 F. Supp. 2d at 294. In particular, the plaintiffs alleged that the underwriters imposed undisclosed "tie-in agreements" on their customers, requiring them "to buy additional shares of the Issuer in the aftermarket as a condition of receiving the right to purchase the IPO stock." *Id.* More than 300 IPOs were alleged to have been tainted by this practice; Fairchild's was not among them. *See id.* at 416-34. More importantly, the case was not a section 16(b) case and had absolutely nothing to do with the type of reclassification at issue here. Furthermore, the claims against the issuers in *Initial Public Offering Securities Litigation* were based on their alleged failure to disclose the underwriters' scheme; here, in contrast, the reclassification was fully and accurately disclosed in the IPO offering prospectus. (*See* A25.)

[4] Respondent represents that "[p]etitioners have acknowledged that Fairchild's IPO was a 'hot' offering." (Br. in Opp. at 3.) Petitioners have not "acknowledged" any such fact, and the portion of the record respondent cites does not support that proposition. (*See* A48.)

2. The Commission's Lack of "Enforcement" or "Adjudicative" Authority Is Irrelevant.

Respondent suggests that the Commission's views on Rules 16b-3 and 16b-7 are entitled to little if any weight because the Commission has no "enforcement" or "adjudicative" authority over claims arising under section 16(b). (*See* Br. in Opp. at 7, 21-22.) Yet again, respondent misses the point.

In section 16(b), Congress expressly delegated to the Commission the authority to promulgate rules and regulations exempting classes of transactions from the statute's broad sweep. *See* 15 U.S.C. § 78p(b). The Commission's lack of "enforcement" or "adjudicative" authority under section 16(b) does not diminish this basic fact. To posit an analogy, under respondent's twisted logic, the enactments of Congress and their underlying legislative history would also be without meaning because Congress does not enforce or adjudicate claims arising under the statutes it enacts. That notion is absurd.

The Commission issued Rules 16b-3 and 16b-7 in the exercise of its congressionally-delegated authority. Under this Court's clear precedents, the plain language of those rules is therefore binding in the courts. *See, e.g., United States v. Mead Corp.*, 533 U.S. 218, 219 (2001); *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984). Moreover, in the event of any ambiguity, the Commission's own interpretation of those rules is controlling absent circumstances not present here. *See, e.g., Auer v. Robbins*, 519 U.S. 452, 461 (1997).

Respondent's reliance on *Christensen v. Harris County*, 529 U.S. 576, 588 (2000), is thoroughly misplaced. According to respondent, in that case "the Court declined to defer to an administrative agency's proffered interpretation of its own regulation *which was contrary to its plain meaning*." (Br. in Opp. at 22 (emphasis added).) Here, the Commission has not offered interpretations of Rules 16b-3(d) and 16b-7 that conflict with their plain meaning.

According to the court of appeals, Rule 16b-7 has no plain meaning. (*See, e.g.*, App. at 14a ("[T]he title and text of the rule, standing alone, do not provide us assistance in our effort to ascertain the SEC's purpose.").) Moreover, the Commission's view of Rule 16b-3(d) is entirely *consistent* with the plain meaning of that rule, which makes no mention of any compensatory-purpose requirement.[5] It is the court of appeals' decision that departed from the plain meaning of Rule 16b-3(d).

3. The Threat of Market Disruption Is Real.

Finally, respondent argues that this Court should deny certiorari because "petitioners cannot point to a single article in any publication supporting their position that the decision has caused, or threatens to cause, disruptions in the markets." (Br. in Opp. at 26.) This assertion is, again, beside the point and, in any event, just plain wrong.

Prior to the denial of a petition for rehearing, it was widely believed that the court of appeals would accept the Commission's view and correct its own decision. As one publication stated:

> It seems highly likely that the Third Circuit will grant the petition for rehearing and that it ultimately will affirm the district court's decision

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[5] The language of Rule 16b-3 is clear and unambiguous; indeed, the court of appeals never found otherwise. Therefore, there was no reason for the court of appeals to resort to the Commission's *interpretations* of the rule – some of which the court apparently did find ambiguous – for guidance. The court of appeals should simply have applied the rule as written. (Of course, if the court of appeals *had* properly reached the Commission's interpretations and found those ambiguous, the most appropriate course would have been to ask the Commission itself for guidance, rather than substituting its own views for the Commission's expertise. Certainly, when that guidance was forthcoming, the court of appeals should not have chosen to ignore it.)

> dismissing the case. However, this process involves several steps and it cannot be taken for granted that they will all fall into place. Accordingly, until this matter is resolved in the Third Circuit, investors and other market participants should use caution in relying upon Rule 16b-3(d) where the acquisition does not involve a compensatory element. Where a purchase does not involve elements of compensation, exemptions or theories other than Rule 16b-3 should be pursued until the Third Circuit removes the cloud over Rule 16b-3(d). Ultimately, it is highly likely that the Third Circuit will lift the pall that has been cast over Rules 16b-3(d) (and 16b-7).

Harold S. Bloomenthal & Samuel Wolff, 3D Sec. & Fed. Corp. Law (2d ed.) § 21:66.50 (2003 update).

Law firm client alerts have also criticized the decision below and urged market participants to act with caution. In a publication to its clients, for example, the law firm Goodwin Procter LLP wrote:

> The decision of the Third Circuit (which has jurisdiction of section 16(b) suits involving Delaware corporations) is contrary to the commonly accepted reading of Rule 16b-3 and, as stated by the SEC in its brief, is inconsistent with the SEC's intention in adopting the rule. If the decision is not reversed, the implications are potentially broad – and unfortunate – for a great variety of transactions involving acquisitions of securities from an issuer.
>
> . . .
>
> [B]ecause this case has introduced a degree of uncertainty (especially with respect to transactions involving Delaware issuers), we urge you to seek the advice of legal counsel when considering [various transactions involving the acquisition of securities from an issuer].

"SEC Files Amicus Brief Urging Third Circuit to Reverse Troublesome Decision Limiting Rule 16b-3 Short-Swing Profit

Exemption to Compensatory Transactions," (Mar. 24, 2003), available at http://www.goodwinprocter.com/publications/CA_Sect16SECBrief_3_24_03.pdf.

Similarly, the law firm Thelen Reid & Priest LLP wrote in an alert to its clients:

> Notwithstanding the unqualified language of the rule and the clear language of the SEC in the adopting release, . . . the Third Circuit held that Rule 16b-3 could not be used to exempt securities transactions between an officer or director and the issuer unless the transaction has "some connection to a compensation-related function."
>
> . . .
>
> Since Rule 16b-3 was adopted in its current form, it has been relied upon to exempt a wide variety of non-compensatory transactions. . . .
>
> . . .
>
> [T]he *Levy* decision can be expected to have an adverse impact on a wide variety of transactions that otherwise would have been structured to take the benefit of Rule 16b-3.

Wayne Kirk, "Third Circuit Limits the Availability of the Short-Swing Profit Exemptions of SEC Rules 16b-3 and 16b-7," (Jan. 27, 2003), available at http://www.thelenreid.com/articles/article/art_168.htm.

In another publication, Thelen Reid noted:

> This decision has thrown into question the ability of executive officers and directors to rely on these exemptions when they sell stock pursuant to a business combination. This decision surprised many practitioners because it appears to run counter to the SEC's analysis of how the exemptions should apply.

Wayne Kirk, "Third Circuit Rejects Petition for Rehearing: Section 16 Short-Swing Profit Exemption Limited in M&A Context," (June 6, 2003), available at http://www.thelenreid.com/articles/article/art_195_idx.htm.[6]

As these publications demonstrate, the court of appeals' decision represents a pronounced shift in the law.[7] The implications of that shift reach far beyond Rules 16b-3 and 16b-7. Indeed, the message the decision sends is that corporate insiders who wish to conform their conduct to the law and avoid liability under section 16(b) should rely on the Commission's exemptive rules at their peril. No matter how clear the language of a rule or the Commission's interpretations of it, at any moment, a court might read into the rule a fact-intensive, case-by-case inquiry into such factors as motive or speculative abuse.

Hence, the court of appeals' decision removes the predictability that the statutory and regulatory scheme was designed to create. In its place is left tremendous uncertainty. It is far-fetched to suggest that this uncertainty would have anything other than a chilling effect. Respondent's demand for "evidence" ignores the fact that the type of market disruption one would expect here – foregone transactions – would be exceedingly difficult, if not impossible, to measure.

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[6] The court of appeals surprisingly denied a request by the Securities Industry Association (the "SIA") to submit an *amicus* brief in support of a petition for rehearing. (*See* Feb. 11, 2003 Order.) Such a brief undoubtedly would have addressed the adverse impact of the decision below on the SIA's members. But the court of appeals opted not to receive it.

[7] The decision surprised even the Commission, which sought leave to file an *amicus* brief in support of a petition for rehearing. While the court of appeals granted the motion for leave, it treated that motion as the Commission's *amicus* brief, and refused to allow the Commission to explain its position further. The court of appeals then denied the petition for rehearing.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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